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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1932

No. 215.

E. G. PALMER, *Petitioner,*

*vs.*

MRS. AGNES McGRAWL BENDER, Administratrix of the Estate of Jacob O. Bender, Late Collector of Internal Revenue for the District of Louisiana, *Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

## REPLY BRIEF OF PETITIONER.

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December 12, 1932.

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*May it Please the Court:*

Since the decision of this Honorable Court in Murphy Oil Company v. Burnet, No. 80, October Term, 1932 (decided December 5, 1932), squarely upholds the validity of Article 215, Regulations 62, as amended, and that regulation being equally applicable to sub-lessors, the brief filed

by respondent herein, is addressed solely to a consideration of the nature of the partnership transactions here involved. Respondent maintains they were assignments, or sales; petitioner contends that they were sub-leases.

We ask the Court to consider this short reply to respondent's brief on that question.

Respondent contends that these instruments are to be construed "according to the sense of the term used and the intention of the parties." The use of the term "to sell, assign, set over, transfer and deliver," and the employment of the habendum clause, do not suffice to characterize these transactions as sales. It is the substance of the contract which determines its nature. It is the intent of the parties as revealed in and effectuated by the entire language in the instrument, which determines its legal definition. United States v. Shea, 152 U. S. 178; Heryford v. Davis, 102 U. S. 235; Gordy v. Maestri, 170 La. 281; Burkett v. Commissioner, 31 F. (2) 667.

In Smith v. Sun Oil Co., 165 La. 907, the Supreme Court of Louisiana held the instrument there involved to be a sub-lease although it was called an assignment, and words of assignment were used in the instrument. Such is consistent with the French authorities therein cited.

In Roberson v. Pioneer Gas Co., 173 La. 313 the same court referred to its former jurisprudence, holding transfers called "assignments", to be sub-leases. In Wilkins v. Nelson, 161 La. 437, the Supreme Court considered a transfer called a "sale," wherein the grantor "sold" all the oil, gas and other minerals for $900.00 and an additional consideration of ⅛ of the oil produced and saved from the premises, with the habendum clause usual to sales, and held the contract to be one of lease.

Respondent seeks to break the force of Roberson v. Pioneer Gas Co., *supra,* by arguing that the point at issue was the effect of drilling performed by the assignee of part of a lease divisible by assignment. That assumption is not

accurate. The defendants were sued for the cancellation of a lease for non-development. The defense was that drilling by a sub-lessee of part of a lease inured to the benefit of the entire lease (Smith v. Sun Oil Co., *supra*); that the drilling had been performed by a sub-lessee, and that, therefore, the lease on the entire tract should not be cancelled. The Supreme Court recognized the rule of law as stated by defendants, but held the transaction to have been an assignment, and not a sub-lease. It was absolutely necessary for the Court to define the status of the transaction, and it discussed that question in terms which fix the transactions involved in this case as sub-leases, beyond any doubt.

Respondent says that petitioner "proceeds upon the erroneous assumption that the mere designation of payments as royalties necessarily determines their character as such" (Brief, p. 20). Petitioner has made no such assumption. At the risk of being redundant, we state our position again, in the language of Logan v. State Gravel Co., 158 La. 105, to be:

> "Our conclusion is that a mine or quarry, or land adapted to mining, or quarrying, may be leased for a certain portion of the produce of such mine or quarry, and the fact that said portion is called "royalty" instead of rent, is not of the least consequence. For "rent" (by whatever name called) is a certain profit in money, provisions, chattels or labor, issuing out of lands and tenements in retribution for the use."

The overriding or excess royalties payable to Smitherman and Baird were "certain portions of the produce" of the leased premises; that is, portions of the oil, and were clearly rents.

The assignment from Baird to the Gulf Refining Company, referred to by respondent as missing from the record, is immaterial, the contract here involved being the contract of November 16, 1921 (R. 313), which, in paragraph 6 (R. 316-317) specifies its essential terms, viz.; that

Baird should have a royalty, payable in oil, so long as oil was produced from the lease in paying quantities.

Respondent says that where a sale provides that a part of the minerals produced are to be paid to the vendor, it becomes a part of the purchase price. Cases are cited, but they are not authority for that proposition. A brief statement with respect to those cases will suffice to show why the citations are inappropriate. With the exception of Pugh v. Commissioner, 49 F. (2), 76, the cases arose in jurisdictions other than Louisiana. They are inapplicable because they involve facts different from the case at bar.

Eldredge v. United States, 31 F. (2) 924, involved the transfer of an option to lease, which became the property of and exercisable only by the transferee. The option was transferred to a third person and the lease was eventually executed by this third person and the landowner, and the transferor of the option was not a party to the lease. The subject-matter of the contract was an option, and not a lease. The citation is inappropriate.

Jefferson Gas and Coal Co. v. Commissioner, 52 F. (2) 120, held a contract requiring minimum annual payments for a term of years, totaling $310,000.00, and providing that at the end of the term a deed in fee simple was to be delivered for a consideration of $1.00, to be in all respects a sale. The Court held the contract to be a sale of the coal in place.

Jamison Coal and Coke Co. v. Commissioner, 24 B. T. A. 554, was substantially the same as Jefferson Coal and Coke Co. v. Commissioner, *supra.*

In Ruth Iron Co. v. Commissioner, 26 F. (2) 30, petitioner first leased a coal property on a royalty basis, which lease was not involved in the case, and later sold the property to the lessee for a fixed price, in cash and notes, secured by a mortgage on the property. The question before the Court was the March 1, 1913, value of the notes for income tax purposes.

In Allen v. Phillips Petroleum Co., 13 F. (2) 584, the Court said:

> "It is clear that the intention of the parties was that the consideration should consist first, of a cash payment of $71,000.00; second, of a further sum of $177,500.00 to be paid from the proceeds of oil produced on and sold from the leasehold by appellants."

There were no royalties involved, and the price was a definite sum, payable in money.

In Pugh v. Commissioner, *supra,* the taxpayer, owner of a plantation, first made an oil and gas lease, not involved in the case. He later sold one-half of his one-eighth royalty for a consideration of $50,000.00 cash and $200,000.00 payable out of the royalty so sold. The price was fixed and determined, payable in money, and a lease was not the subject-matter of the case.

In United Central Oil Corp. v. Helm, 11 F. (2) 760, the defendant agreed to pay the plaintiff for the assignment of an oil and gas lease the sum of $60,280.25, one-half cash and the balance "out of the first one-half of all the oil or gas produced and saved from said lease". The price was fixed and determined and payable in money.

The citation to Thortnon, "Law of Oil and Gas", (5th Ed.), is merely an academic discussion of the nature of royalty and rent, and has no specific application to respondent's premise.

In each case cited, where the sale of a lease or minerals was discussed, the price was payable in cash, and in a fixed amount. In none of these cases did the payment consist "in a certain quantity of commodities, or even in a portion of the fruits yielded by the thing leased".

We have repeatedly challenged respondent to cite one Louisiana case wherein royalty consisting "in a certain quantity of commodities, or even in a portion of the fruits yielded by the thing leased" has been held to be other than rent. To date no such case has been cited.

Respondent says, "We are not aware of any statute or of any decision in Louisiana which prohibits a sale of mineral rights with the provision that part payment of the purchase price shall be out of the yield of the property". (Br. 21)

In reply, and at the risk of repetition, we again quote from the Revised Civil Code:

> "Article 2464. The price of the sale must be certain, that is to say, fixed and determined by the parties. It ought to consist of money, otherwise it would be an exchange."

See also Article 1764.

> "Article 2660. Exchange is a contract by which the parties to the contract give to one another, one thing for another, whatever it be, except money; for in that case it would be a sale".
>
> "Article 2671" (under Title IX, "Of Lease"): "The price should be certain and determinate, and should consist of money. However, it may consist in a certain quantity of commodities or even in a portion of the fruits yielded by the thing leased".

Under the plain wording of these articles, of statutory sanction, a contract, the price of which consists "in a portion of the fruits yielded by the thing" cannot be a sale or an exchange, but must be a lease.

Under these articles, a contract providing for a cash bonus, and a royalty payable in oil, cannot be a sale, because the price is not certain and does not consist in money. It cannot be an exchange, because a thing is not given for another thing, and the price consists partly in money. It is bound to be a lease, because the price, in addition to money, consists of "a portion of the fruits yielded by the thing."

These considerations have lead the Supreme Court of Louisiana to repeatedly and consistently hold such contracts to be leases. Spence v. Gravel Co., *supra;* Logan v.

State Gravel Co., *supra;* and Wilkins v. Nelson, 161 La. 437.

Respondent has referred to Article 2786 of the Revised Civil Code as recognizing that property may be sold with rent reserved. That citation is likewise inappropriate. Article 2671 of the Code, referring to the price of a lease, is found under Title IX, entitled "Of Lease". Article 2786, to which reference is made is found under Title X, entitled "Of Rents and Annuities," Chapter 1. "Of Rent of Lands," Articles 2778-2792.

Whereas, in Louisiana the grant of minerals conveys no specific thing, but only the right to extract them from the soil, in the nature of a servitude. Frost-Johnson Lumber Co. v. Sallings, 150 La. 855; Wemple v. Nabors, 154 La. 483. Such a servitude, defined in Article 647 of the Civil Code, could not be the subject of a contract of "rent of lands" as defined in articles 2779, *et seq.* of the Code, which refer to sales of land, or other immovable property in perpetuity for a perpetual charge, called rent.

Such discussion, however, is academic, because, by positive declaration of the Supreme Court, the law of lease applies to mineral contracts in Louisiana. In Spence v. Lucas, 138 La. 763, the Court said:

> "Until the Legislature shall have passed laws specially applicable to the industry of mining, which is a new one in this state, the parties engaged in those pursuits and the courts of the state will adhere to jurisprudence on the subject, and treat mineral contracts as leases."

Nearly ten years later, the Supreme Court of Louisiana, in Logan v. State Gravel Company, 158 La. 105, quoted this language from Spence v. Lucas, *supra,* and said,

> "This expression has stood upon the books for nearly 10 years, and since then the Legislature has met seven times without making any change in the law, in that respect, although the industry has greatly devel-

oped since then and many laws have been passed on the subject thereof. We conclude that the legislator is satisfied with the law of the case last cited, and hence we now reaffirm the principle therein announced. We think plaintiffs entitled to a lessor's privilege on the property sought on the leased premises".

Respondent argues that the partnerships divested themselves of their entire interest in the leases. However, considering that the grant of minerals in Louisiana does not convey any specific, corporeal thing, but only the right to extract them from the soil, in the nature of a servitude (Frost-Johnson Lumber Co. v. Sallings, *supra;* Wemple v. Nabors, *supra,* it is obvious that the partnerships to the extent of their royalty interests, payable in oil, had interests equal to those of the original lessors, whose interests remaining were royalties payable in oil.[1] See the opinion of the Trial Court. (R. 111) This Court has recognized that a sub-lessor, entitled to receive royalty, had a depletable interest in the leased property. (Lynch v. Alworth-Stephens, 267 U. S. 364)[2]

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[1] The lease from the landowner to Smitherman reads (R. 205-206):

> "To have and to hold unto said lessee, successors and assigns, for the term and under the provisions, as follows, to wit: * * * Third, If, in the exercise of the right hereby conferred, oil or gas be found in paying quantities, then the lessee shall deliver as royalty to said Mrs. Anna Taylor, et als., free of expense, one-eighth (⅛) part of all oil saved from that produced. * * *"

The Smitherman-Ohio Oil transaction reads (R. 243):

> "To have and to hold unto the said Ohio Oil Company, its successors and assigns for and in consideration of the sum and price of Three Million Dollars Cash * * * and subject to the further obligation of the said assignee, its successors and assigns, to pay over and deliver to said assignor, the equal one-eighth (⅛) of all oil produced and saved from the above described premises as an excess royalty. * * *"

[2] Judge Bryan, the organ of the Court in the Waller, Herold and Palmer cases, said that an assignment of all the interest of the assignor, except a reserved royalty, is not an abandonment of a lease (Emerson v. Little Six Oil Co., 3 F. (2) 265); and on the strength of that decision the Montana Supreme Court held the retention of an over-riding royalty characterizes the transfer of an oil and gas lease as a sub-lease. (McNamara Realty Co. v. Sunburst Oil Co., 76 Mont. 332; 247 Pac. 166.)

Respondent says that neither Logan v. Gravel Co., *supra*, or Board of Commissioners v. Pure Oil Co., 167 La. 801, holds that the relationship of landlord and tenant existed because the royalty was rent. We shall answer him in the language of the Supreme Court of Louisiana, which in Logan v. State Gravel Co. said:

> "The sole question presented is whether the contract is one of lease; the parties having agreed as follows: 'It is understood that the matter is submitted to the Court on the question of the legal effect of the document sued on; there is no dispute as to the amount of the indebtedness claimed in the petition.' "

The determining factor which conduced to the holding in both cases that the contracts were leases, was the nature of the consideration, which, under the very plain terms of the Code was rent.

We cited articles 2711, 2712 and 2729 of the Civil Code and Louisiana Oil & Refinery Co. v. Cozart, 163 La. 90, in reply to the observation of the Circuit Court of Appeals that the failure of the Ohio Oil Company to deliver Smitherman one-eighth of the oil as an excess royalty, would not affect its rights to take the other seven-eighths. Of course we were arguing from effect to cause, even as did the Court. But whatever the nature of the contract, the Circuit Court was in error, because Article 2046 of the Civil Code provides:

> "A resolutory condition is implied in all commutative contracts, to take effect, in case either of the parties do not comply with his engagements; in this case the contract is not dissolved of right; the party complaining of a breach of the contract may either sue for its dissolution, with damages, or if the circumstance of the case permit, demand a specific performance."

The jurisprudence of Louisiana with respect to oil and gas leases, and their transfer by sub-lease, or assignment,

has resulted from a logical and consistent application of articles of the Civil Code which have remained unchanged for more than a century. The principle that the price of a sale must be a certain sum in money, while that of a lease may consist in a "certain quantity of commodities or even in a portion of the fruits yielded by the thing leased," is rigid. Irrespective of the circumstances which have presented questions in which it was involved, its application has always been logical. Mineral contracts providing for the payment of royalties (a portion of the fruits yielded by the thing leased), have always been held to be leases. The jurisprudence of the State that the retention of an over-riding royalty characterizes the transfer of an oil and gas lease as a sub-lease, is but a logical application of that principle, for a sub-lease is, in effect, a new lease, while an assignment is a sale.[3]

We respectfully submit that the transactions between Smitherman and the Ohio Oil Company, and Baird and the Gulf Refining Company, were clearly sub-leases, and that the decisions of the United States Circuit Court of Appeals for the Fifth Circuit and of the United States District Court for the Western District of Louisiana, in so far as they are prejudicial to petitioner herein, should be reversed.

All of which is respectfully submitted,

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December 12, 1932.

[3] As evidence that this is the accepted view in Louisiana, see VI Tulane Law Review No. 2, page 312. (February, 1932)